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Authorities Cited.

In the Supreme Court of the United States.

OCTOBER TERM, 1920.

DAVID M. GOODRICH, PLAINTIFF IN ERROR, *v.* WILLIAM H. EDWARDS, UNITED STATES Collector of Internal Revenue for the Second District of the State of New York.	No. 663.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR THE DEFENDANT IN ERROR.

This case is here on writ of error to review the action of the District Court in sustaining a demurrer and dismissing the suit of the plaintiff in error brought to recover certain income taxes for the year 1916 paid under protest.

THE FACTS.

Two items of income which the plaintiff in error was required to include in his return and upon which he paid taxes are involved.

1. In 1912 he purchased 1,000 shares of the capital stock of a mining company at 50 cents per share, paying in all \$500. On March 1, 1913, the stock had advanced in price until it was worth 69½ cents per share, or \$695. He held it, however,

until 1916, when it was worth more than $13 a share, and sold it for $13,931.22. As a result, the Commissioner of Internal Revenue required him to report an item of income equal to the difference between the selling price and $695, its value on March 1, 1913, or $13,236.22.

2. Prior to 1912 he was the owner of certain shares of stock in the B. F. Goodrich Company, a corporation of the State of Ohio, which he had previously received by gift and bequest from his mother. In 1912 this Ohio company transferred its business and assets to a new corporation of the same name organized under the laws of New York. The plaintiff in error exchanged his shares of stock in the Ohio company and received in return cash and shares of stock in the New York corporation. At that time the fair market value of the shares in the New York corporation was $81 per share, making the value of 3,600 shares received by plaintiff in error $291,600. On March 1, 1913, however, their value was only about $41.25 per share, or $148,635.50. Subsequently they increased in price until they were sold in 1916 for $269,346.25. This was $22,253.75 less than their value in 1912 but $120,710.75 more than their value on March 1, 1913. He was required to report this latter amount as an item of taxable income.

STATUTE INVOLVED.

The taxes in question were collected under the provisions of the act of September 8, 1916 (39 Stat., c. 463, p. 756), as amended by the act of October 3,

1917 (40 Stat., c. 63, p. 300). Section 1 (a) and (b) of the act of 1916 levied certain income taxes to be paid annually upon the entire net income received in the preceding calendar year from all sources by every individual a citizen or resident of the United States. This was amended by the act of 1917 only with respect to the rate of taxation.

Section 2 (a) defines net income of taxable persons as follows:

> That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership, or use of or interest in real or personal property, also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: * * *.

And section 2 (c) contains a specific provision for ascertaining the gain derived from a sale of property, acquired prior to March 1, 1913, as follows:

> For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen

hundred and thirteen, shall be the basis for determining the amount of such gain derived.

QUESTIONS INVOLVED.

(1) The fundamental contention of the plaintiff in error is that the proceeds of the sale of capital assets do not, in any event, include anything which Congress has the power to treat as income for purposes of taxation.

(2) With respect to the second item mentioned above, the plaintiff in error contends that, even if mistaken in his principal contention, there is no income in the case of a sale of stocks at less than their cost but more than their value on March 1, 1913, since, in that case, the whole transaction shows a loss and not a gain.

BRIEF.

I.

Reference to the Government's brief in Merchants Loan & Trust Company v. Smietanka, No. 608, at the present term.

Except for the question raised by the second contention above stated, the question involved in this case is the same question involved in *Merchants Loan & Trust Company* v. *Smietanka*, No. 608, which was argued in January and is under consideration by the court. To avoid repetition, the attention of the court is again called to the Government's brief in that case and to the argument there made in support of the following propositions:

1. The acts of Congress expressly include in taxable income gains, or profits derived from "sales" of real

or personal property. The intention, therefore, to tax income derived from the conversion of capital assets is clear.

2. Giving effect to the rule that the word "income" as used in the sixteenth amendment and in the acts of Congress is to be understood as it is understood in common speech, this court has said that—

> "income" may be defined as the gain derived from capital, from labor, or from both combined. (*Stratton's Independence (Ltd.)* v. *Howbert*, 231 U. S. 399, 415.)

And repeating this definition in the late case of *Eisner* v. *Macomber* (252 U. S. 189, 207), Mr. Justice Pitney expressly construed it to include profits derived from the profitable sale of capital assets by adding:

> provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case.

3. This court has emphatically rejected the contention that the entire proceeds of the conversion of capital assets shall be treated as the same capital, changed only in form and containing no element of income, although including an increment of value, and has expressly held that, while conversion of capital assets does not always produce income, but that, when the selling price is less than cost, the result is a loss or outgo—

> Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the "gross income"

received "from all sources." (*Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185.)

4. A mere increase in value, while it remains such, is not income. In order that it may become income, something must be done to segregate it from capital so that the owner may use it or dispose of it without using or disposing of the capital to which it is an incident. This something, however, is done when the capital asset is converted into cash, so that the increment of value or profit may be withdrawn and leave the capital intact.

5. The word "income," as used to describe the thing upon which the present act imposes a tax, means, necessarily, the same as the word "income" by which in the act of 1909 the corporation excise tax was to be measured. As used in the latter act, the administrative branch of the Government has, from the beginning, construed it as including gains derived from the profitable sale of capital assets. This construction has uniformly received the approval of this court, and, under it, millions of dollars of taxes have been collected.

6. *Gray* v. *Darlington* (15 Wall. 63), is not applicable to the present controversy. This court held in *Hays* v. *Gauley Mountain Coal Co.* (247 U. S. 189), that it was not controlling in a case arising under the act of 1909 because that act measured the tax by the income *received* during the taxable year. True, in *Lynch* v. *Turrish* (247 U. S. 221), it was said that *Gray* v. *Darlington* could not be distinguished from a case arising under the act of 1913, which levied a tax upon income *arising or accruing* during the

taxable year. The present act, however, goes back to the language of the act of 1909 and imposes the tax upon income *received* during the taxable year.

For the full argument in support of these propositions, reference is made to the Government's brief in No. 608, and the present brief, avoiding, as much as possible, repetition, will be directed to replying specifically to the arguments now advanced in this case.

II.

Prior to the adoption of the sixteenth amendment, the word "income," as understood by the legislative, the executive, and the judicial branches of the Government, included gains or profits derived from the sale of capital assets.

It is, of course, conceded that the sixteenth amendment gave no new meaning to the word "income." It merely dealt with the power of Congress to tax incomes, assuming that the word "income" had a well-understood meaning. This was no mistaken assumption. All branches of the Government had, during a period of many years, dealt with the subject of incomes. A review of these dealings shows that no department of the Government had ever entertained any doubt that gains resulting from the profitable sale of capital assets were included in the term "income" as generally understood. There had been some differences of opinion as to the extent to which such gains should be taxed, with particular reference to the period during which they had accrued; but that they, in fact, constituted income has never until recently been doubted.

In 1861 Congress imposed a tax on "annual income." (12 Stat., c. 45, p. 292.) This act, however, was never put into effect. (Seligman, Income Tax, p. 435.) The act of July 1, 1862 (12 Stat., c. 119, pp. 432, 473), imposed a tax to be paid annually upon "annual gains, profits, or income," making no specific mention, however, of gains from the sale of capital assets. The Commissioner of Internal Revenue ruled that profits from the sale of real estate were to be considered income irrespective of the time when the property had been purchased. (The Cong. Globe, May 27, 1864, p. 2516.) Because of this interpretation put upon the law, the propriety of taxing such gains which had accrued during a period of years, and before the enactment of the income tax law, became the subject of discussion in Congress when the income tax law of 1864 was under consideration. That such gains constituted income was not questioned, except perhaps as to that portion which had accrued during prior years, and the justice of a tax on that portion of the gains was sharply called in question. The committee having the bill in charge, to meet this injustice, proposed the following:

> *And provided further,* That net profits realized by sales of property upon investments made within the year, for which income is estimated, shall be chargeable as income; and losses on sales of property purchased within the year, for which income is estimated, shall be deducted from the income of such year. (Cong. Globe, p. 2516.)

This was plainly predicated upon the recognized fact that gains derived from the sale of property purchased as an investment constituted income. But the committee thought that the tax should be levied only in cases where the investment and the sale were made during the same year. In explaining the committee's action, Senator Fessenden, after stating that the commissioner had ruled that, where a man purchased land and held it for a period of years and sold it in any given year, he must account for, as income of the year, the profit over and above the cost, making allowance for taxes, interest, etc., said:

> That was the construction the commissioner put upon it in writing. Our difficulty was to fix any ratio of income. If anything could be considered as income in such case, it is the increase of value for the year. If, for instance, you buy property one year and hold it, and by last year's accumulation on it it became so much more valuable, that might be considered as income when you sold it; but how could you tell very readily what that was? The committee, therefore, in considering the question and looking into the difficulties that surrounded it, came to the conclusion that the only mode in which it could be arranged—and it should certainly be fixed in some way—was to provide that if a person sells property of any sort within the year you may estimate the increased value, what he made upon the transaction, as income; but certainly it should not apply to purchases existing before we ever thought of passing an income tax or internal revenue tax.

> We fixed it in that way, coming to the conclusion that that was the only reasonable mode in which to fix it, and trusting that if the House differed with us in opinion they would enable us to establish some other rule that would be better than ours. (Cong. Globe, pt. 3, p. 2516.)

At that date, then, the question was not whether gains of this kind constituted income but to what extent they should be taxed when they had accrued during a period of years prior to the enactment of the tax law. The amendment above quoted was agreed to by the Senate. But, in the further progress of the bill through Congress, it was somewhat changed so that, as finally passed, the act of June 30, 1864 (13 Stat., c. 173, p. 223), contained the following:

> *And provided further*, That net profits realized by sales of real estate purchased within the year, for which income is estimated, shall be chargeable as income; and losses on sales of real estate purchased within the year, for which income is estimated, shall be deducted from the income of such year. (13 Stat., c. 173, p. 281.)

Thus Congress determined that it would tax income of this kind only when it resulted from a purchase and a sale made within the same year. This carries no implication of a want of power to tax such gains accruing previously but realized and received during a taxable year. It merely gives expression to the opinion entertained, at that time, that Congress should not go back of purchases made during the tax year.

The same provisions are carried into the act of March 3, 1865. (13 Stat., c. 78, p. 469.)

When Congress came to pass the act of March 2, 1867 (14 Stat., c. 169, p. 471), it was evidently of the opinion that the acts of 1864 and 1865 had been too restricted in this respect. The rule then adopted might be well enough in the case of personal property, which is the subject of more frequent purchases and sale, but real estate, as a rule, does not change hands so rapidly. At any rate, Congress thought that the profits realized from the sale of real estate should be taxed, even though the purchase and sale were not both made within the same year. It still thought, however, that the act should be restricted to such gains accruing during a comparatively short period. Hence, it inserted in the act of 1867 that, in estimating income for a given year, there should be included—

> profits realized within the year from sales of real estate purchased within the year or within two years previous to the year for which income was [is] estimated. (14 Stat., p. 478.)

Thus, all gains derived from the sale of real estate were taxed in the year in which received, provided the real estate had been purchased within the two preceding years. This, however, was an exception to the general rule applied in the statute that only gains derived from a transaction begun and ended in a given year should be treated as the income of that year. The point is that Congress fully understood that such gains constituted income. If they were income when they had accrued during a period

of two years, they were equally income if they had accrued during a period of 5 or 10 years.

The act of 1867 came before this court in *Gray* v. *Darlington.* (15 Wall. 63.) The question was whether a profit of $20,000, received by a sale in 1869 of bonds purchased in 1865, was taxable as income for the year 1869. The case involved no question as to whether this profit or gain was income, but only the question as to whether it was income which had been made taxable by the act of 1867. The syllabus of the case correctly limits the decision to a holding that an advance in the value of personal property during a series of years under the act of March 2, 1867, does not constitute income *of any one particular year of the series,* although the entire amount of the advance be at one time turned into money by the sale of property. Throughout the opinion it is made clear that this is the only point involved and that there is no question as to whether such gains are, in general, included in the term "income." Thus, at the very outset, in quoting the provisions of the statute, the court italicises the words "for the year ending the 31st of December next preceding," although these words are not italicised in the act. The provision above quoted, with respect to profits derived from the sale of real estate, is then set out. After stating the facts with respect to the purchase and sale of the bonds in question, the court said:

> The question presented is whether the advance in the value of the bonds, during this

> period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. (Id., p. 65.)

It was not meant by this that the power of Congress to make such gains taxable for a given year was involved, but only that the question was whether the act of 1867 had made them so taxable. The court accordingly took up the statute and said:

> The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income. Its general language is "that there shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person," derived from certain specified sources, a tax of 5 per cent, and that this tax shall be "assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December next preceding the time for levying, collecting, and paying said tax." This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. (Id., p. 65.)

Thus the court construed the act of 1867 as expressing a purpose to tax profits realized from business transactions only when those transactions were begun and completed during the tax year. Mention was then made, however, of certain exceptions to this

general rule that the transaction must be begun and ended during the same year, the court saying (pp. 65–66):

> One of these exceptions is expressed in the statute, and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased not only within the preceding year but within the two previous years.

The conclusion was thus reached that, saving only the exceptions made by the statute, in the case of sales of property, Congress had intended to tax only the profits derived from both a purchase and sale during the same year. An exception, however, was made of sales of real estate. The bonds involved were not within any of the exceptions, and it was, of course, held that Congress intended that profits derived from their sale should be taxed only under the general rule of the statute. In the case, therefore, of sales made by investors, not as a part of a general trading business, the court assumed that, in the case of real estate, all profits accruing during a period of two years prior to the taxable year, as well as those accruing during the latter year, were taxable under the statute. That no doubt was entertained of the power of Congress to tax as income such profits when received, regardless of when the property sold had been purchased, is made clear by a further discussion of other features of the statute.

In the case of isolated sales by investors, the question simply is how much income has been

derived from a single transaction. It has always been recognized, however, as fair that where one is dealing, as a part of his trade or business, in property, buying and selling it, his net income shall be regarded as what he has derived from all such transactions. This was contemplated by the act of 1867, and the court said (p. 66):

> Another exception is implied from the provision of the statute which requires all gains, profits, and income derived from any source whatever, in addition to the sources enumerated, to be included in the estimation of the assessor. The estimation must, therefore, necessarily embrace gains and profits from trade and commerce, and these, for their successful prosecution, often require property to be held over a year. In the estimation of gains of any one year the trader and merchant will, in consequence, often be compelled to include the amount received upon goods sold over their cost, which were purchased in a previous year. Indeed, in the estimation of the gains and profits of a trading or commercial business for any one year, the result of many transactions have generally to be taken into account which originated previously. Except, however, in these and similar cases, and in cases of sales of real property, the statute only applies to such gains, profits, and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected.

The court was also interpreting a particular statute and not dealing with the question of what is ordinarily included in the term "income" when it said:

> The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital. (Id., p. 66.)

The holding is not that, when such advance in value is realized by a sale, it is not income within the general meaning of that word, but only that it is not *the income specified by the statute.*

And in the concluding paragraph of the opinion it is made perfectly clear that, when the court speaks of income, it refers only to the income specified by the particular statute under consideration. It was said:

> The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in 10 years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes

place. We are satisfied that no such result was intended by the statute. (Id., p. 66.)

When the income tax acts of the sixties were passed the word "income" had the same meaning which it has now. When the first act levied a tax on annual gains, profits, and income, the executive department of the Government understood that profits derived from the sale of capital assets, no matter when purchased, were included. This brought the matter to the attention of Congress, where the construction adopted by the executive department was assumed to be correct. On this assumption, Congress considered not the power but the policy of taxing in a particular year such gains received in that year after having accrued over a period of years. It manifested its understanding that such gains constitute income by taxing them in some cases when the transaction out of which they arose had both commenced and ended in the same year, and in other cases when they had commenced and ended during a period of three years. In *Gray* v. *Darlington*, *supra*, the court, at least, assumed that the legislative conception of income and of the power to deal with it was correct. It did not question the power of Congress to treat as income for a particular year profits of this kind accruing during a period of years, but only held that, in the case of profits arising from the sale of bonds, Congress had not intended to levy the tax unless the transaction both began and ended during the same year. Certainly, at that time,

every department of the Government understood the term "income" to include gains derived from the profitable sale of capital assets.

When the act of August 27, 1894 (28 Stat., c. 349, p. 509), was passed Congress still understood that income included gains of this kind, and provided that in estimating gains, profits and income of any person there shall, among other things, be included—

> profits realized within the year from sales of real estate purchased within two years previous to the close of the year for which income is estimated. (28 Stat., p. 553.)

That statute, as is well known, was held in the *Pollock* case (158 U. S. 601) to be unconstitutional, not because gains derived from the sale of real estate were not income but because the tax upon rents and certain other things were, in effect, direct taxes upon property and could not, at that time, be levied without apportionment among the States. The act was subjected to the careful scrutiny and criticism of many eminent counsel, including the distinguished counsel for plaintiff in error in the present case. Every possible objection was made to the validity of the statute. As shown above, profits realized from the sale of real estate purchased within two previous years were classed with all other forms of income. And yet so well was this understood by the profession to be income that, in as powerful an assault as was ever made upon an act of Congress, the contention now advanced was apparently not thought of by counsel. If it did not occur to the

eminent counsel employed in that case—that such gains were not income—it may safely be assumed that, as generally understood at that time, the term "income" included gains derived from the profitable sale of capital assets.

The corporation excise tax act of August 5, 1909 (36 Stat., c. 6, pp. 11, 112), imposed "a special excise tax with respect to the carrying on or doing business" by corporations "equivalent to 1 per cent upon the entire net income * * * received by it from all sources during such year," and required corporations, under regulations to be provided by the Secretary of the Treasury, to report "for the year ending December 31, 1909, and for each calendar year thereafter," among other things, "the gross amount of the income of such corporation" received within the year from all sources. It was provided that the net income by which the tax was to be measured should be ascertained by making certain deductions from the gross income. No effort, however, was made to define "income." Apparently, Congress felt that no definition was necessary, since the term "income" already had a well-understood meaning. As we have seen, all branches of the Government had construed it to include the gains derived from the profitable sale of capital assets. Following this construction, the Secretary of the Treasury, in T. D. 1571, promulgated December 3, 1909, included the following:

> *Sale of capital assets.*—In ascertaining income derived from the sale of capital assets, if

> the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price.

And in T. D. 1606, promulgated March 29, 1910, section 71 was:

> Where increase or decrease during the year in the value of real estate acquired in previous years, sold or held for sale, can not be accurately determined, such increase or decrease may be prorated, as provided by regulations in cases of sale of capital assets.

And T. D. 1675, February 14, 1911, article 55 was:

> Lands bought previous to January 1, 1909, and sold during the year 1910, should have the profits arising from such sale prorated in accordance with the number of years the land was held by the corporation and the number of years the law was in effect, if no accounting of increased value of land was made in returns for previous years.

The same provision was in T. D. 1742, December 15, 1911.

The interpretation thus put by the Treasury Department upon the act of 1909, by including, in income, the gain derived from the sale of capital assets, has been repeatedly approved by this court. In *Stratton's Independence (Ltd.)* v. *Howbert* (231 U. S. 399), holding that income included the profits derived

from ores mined by a corporation from its own premises, the court, at page 415, defined income as follows:

> "Income" may be defined as the gain derived from capital, from labor, or from both combined.

In *Doyle* v. *Mitchell Bros. Co.* (247 U. S. 179), the precise contention now made was urged upon the court. In that case the company had acquired timber lands in 1903 at $20 an acre. Owing to increases in the market price of stumpage, the market value of these lands on March 1, 1913, was $40 per acre. The company was not a real estate trading corporation. It was engaged in manufacturing lumber from timber cut from its own lands. It was not questioned that the profits realized by the sale of this lumber constituted income; or that, in determining the amount of such profits, there must be deducted from the proceeds of sale not only the cost of manufacture but also the value of the stumpage. The company claimed the right to deduct this value as of December 31, 1908, at the rate of $40 per acre. The commissioner ruled, however, that it was entitled to the deduction only at the original cost of $20 per acre. The question, therefore, was whether the income contemplated by the act of 1909 included the profits resulting from the increase in price between 1903 and 1908, or whether this portion of the profit should be excluded and only that which could be said to have accrued after December 31, 1908, included. The court entertained no doubt that profits made by the sale of capital assets were income. A suggestion to

the contrary was decisively rejected, Mr. Justice Pitney saying, at page 183:

> The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income, although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received "from all sources."

The only difficulty arising in the case was thus stated:

> When we come to apply the act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the act, questions of difficulty are encountered. (Id., p. 183.)

Rejecting also the contention on the part of the Government that the entire proceeds of a mere conversion of capital assets were to be treated as gross income, it was said, after referring to the definition of income above quoted from *Stratton's Independence* v. *Howbert:*

> Understanding the term in this natural and obvious sense, it can not be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many

> if not in most cases there results a gain that properly may be accounted as a part of the "gross income" received "from all sources"; and by applying to this the authorized deductions we arrive at "net income."

And then, laying down the rule for determining the income included in the proceeds of a sale, it was said:

> In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration. (Id., p. 185.)

The court then mentioned the fact that this was the view taken by the administrative officers of the Government from the beginning and, after reviewing the Treasury Decisions above quoted and others, said:

> In our opinion these regulations correctly interpret the act in its application to the facts of the present case. (Id., p. 187.)

Even more decisive is *Hays* v. *Gauley Mountain Coal Co.* (247 U. S. 189). The company in that case was a mining corporation. The business of trading in stocks was not included among its corporate powers, and it did not appear that, with a single exception, it ever bought or sold any. The single exception was the transaction involved in that case. That transaction was that the company had bought certain shares of stock of another company in 1902 for $800,000

and sold them in 1911 for $1,010,000, or an advance of $210,000. The question was whether the portion of this $210,000 which could be said to have accrued after January 1, 1909, should be included in the income by which the excise tax was to be measured. There was a contention that, at all events, interest on the amount originally invested should be deducted. This, however, was rejected by the court and the question squarely presented as to whether any portion of the $210,000 was income within the meaning of the act. The same contention now made was made in that case, and then, as now, rested chiefly upon *Gray* v. *Darlington, supra.* The court held, however, that that case was not controlling, saying, at page 191:

> We do not regard the decision as controlling, because the language of the act now under consideration is different in material particulars. As pointed out in *Doyle* v. *Mitchell Brothers Company, ante,* 179, it imposes annually a special excise tax with respect to the carrying on or doing business by the corporation "equivalent to 1 per cent upon the entire net income over and above $5,000 received by it from all sources during such year," to be ascertained by taking gross income and applying certain exceptions and deductions. "Gains, profits, and income *for* the year ending the 31st day of December next preceding" (act of 1867) conveys a different meaning from "the entire net income * * * *received by it* * * * *during* such year." (Act of 1909.) The former expression,

> as this court held (15 Wall. 65), denoted "such gains or profits as may be realized from a business transaction begun and completed during the preceding year," with the exceptions already mentioned. The expression "income *received during* such year," employed in the act of 1909, looks to the time of realization rather than to the period of accruement, except as the taking effect of the act on a specified date (Jan. 1, 1909), excludes income that accrued before that date.

And speaking still of the act of 1909, as applied to profits derived from the sale of capital assets, it was said, at page 192:

> As we construe the latter act, it measured the tax by the income received within the year for which the assessment was levied, whether it accrued within that year or in some preceding year while the act was in effect; but it excluded all income that accrued prior to January 1, 1909, although afterwards received while the act was in effect.

And finally the court, at page 193, announced its conclusion thus:

> "It results that so much of the $210,000 of profits as may be deemed to have accrued subsequent to December 31, 1908, must be treated as a part of the "gross income" of respondent. For it is the simple case of a conversion of capital assets acquired before and turned into money after the taking effect of the act; and, as we have shown in *Doyle* v. *Mitchell Brothers Co.*, *ante*, 179, since the

conversion of capital often results in gain, the general purpose of the act of 1909 to measure the tax by the increase arising from corporate activities together with the income from invested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as "gross income;" and to this end it must be distinguished from that portion which represents a return of the capital value existing before. In order to do this, it is necessary to ascertain what was the value of the capital assets on December 31, 1908.

Whether the division of such income should be made by the prorating method provided by the Treasury regulations, above referred to, or by taking an inventory as of December 31, 1908, was not determined, for the reason that the prorating method had not been called in question.

There can be no doubt that the decisions referred to establish beyond controversy that when the act of 1909 measured the excise tax, then levied, by the net income of a corporation it included, in income, gains derived from the sale or conversion of capital assets, and provided that the amount of such income for a praticular year should be ascertained by first withdrawing from the proceeds of sale either the original cost or the value on the effective date of the act of the property subsequently sold, the remainder representing income received in the year of the sale. The fact that the act of 1909 was not an income-tax

law does not preclude these rulings from being decisive of the present case. Admittedly, the question here is what, in common speech, is meant by income. The word "income" can not be said to have been used in any unusual or extraordinary sense in the act of 1909. Although employed for a different purpose, it was used in exactly the same sense that it was used in the sixteenth amendment and the subsequent income-tax acts. In the act of 1909 it was used in the sense in which it had been used by all branches of the Government for many years. The meaning attached to it by this court, in interpreting the act of 1909, must be its meaning when used, without any qualifying words, in subsequent legislation.

The act of October 3, 1913 (38 Stat., c. 16, pp. 114, 166), was the first income tax law after the adoption of the sixteenth amendment. It levied a tax, to be paid annually, upon the entire net income "arising or accruing from all sources in the preceding calendar year." Its effective date was March 1, 1913. It provided that there should be included, in income, gains, profits, and income derived from, among other things, sales or dealings in property. It did not contain any provision for ascertaining such gains where the property was acquired before March 1, 1913, and subsequently sold. It will be seen that this act is like the act of 1909 in expressly fixing a date upon which it should become effective, but unlike that act in that, while the act of 1909 levied a tax to be measured by the income *received* during a

particular year, the act of 1913 levies a tax upon income *arising or accruing* during the year.

The first case under the act of 1913 was *Lynch* v. *Turrish* (247 U. S. 221), which is strongly urged by counsel upon the court as applying to the act of 1913 a rule different from that applied, by the cases above cited, to the act of 1909. An examination of the case, however, will show that there is nothing in the *Turrish* case which, in any way, recedes from the former decision that gains derived from the sale of capital assets are income. The question was whether Turrish should be required to report, as a part of his income for the year 1914, certain sums which he had received upon the distribution, by a corporation in which he was a stockholder, of all its assets. It appeared, however, that there had been no increase in the value of the assets so distributed between March 1, 1913, and the date of distribution in 1914. This was regarded as of controlling importance, for it was said (page 226):

> And in determining the application of the statute to Turrish we must keep in mind that on the admitted facts the distribution received by him from the Payette Company manifestly was a single and final dividend in liquidation of the entire assets and business of the company, a return to him of the value of his stock upon the surrender of his entire interest in the company, and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect.

In other words, the rule announced in the cases cited above, dealing with the act of 1909, that there is no gain or income until, out of what one receives for his holdings, there has been withdrawn the amount of his capital represented either by original cost or the value as of the effective date of the act. Turrish having received only his capital as it existed on March 1, 1913, it was held that he had received no income. Meeting apparently the contention that whether there had been a gain was not to be determined by the value of the assets on March 1, 1913, but by the amount of the original investment, the court held that *Gray* v. *Darlington* (15 Wall. 63) was controlling, because it could find no substantial difference between the language of the act of 1867 and that of 1913. This by no means determined that such gains as we are now considering are not income, but only that the terms of the act of 1913 exclude such income which accrued prior to the effective date of that act. This holding is not in any way in conflict with *Hays* v. *Gauley Mountain Coal Co.*, *supra*. In that case it was found that there was a distinguishing difference between the act of 1909 and the act of 1867, which called for the application of different rules of interpretation, and hence *Gray* v. *Darlington* was not controlling. In the *Turrish* case the act of 1913 was held to be like the act of 1867 and unlike that of 1909, and hence *Gray* v. *Darlington* was controlling. It will be seen later that the act of 1916, under which this case arises, abandoned

the language of the acts of 1867 and 1913 and adopted the language of the act of 1909. Hence, *Hays* v. *Gauley Mountain Coal Company* and not *Gray* v. *Darlington* is controlling.

That this court has utterly and finally rejected the contention that the profitable sale of capital assets does not result in income was made clear in *Eisner* v. *Macomber* (252 U. S. 189), arising under the act of 1916, when, at page 207, Mr. Justice Pitney, after repeating, from *Stratton's Independence* v. *Howbert*, the statement that " 'income' may be defined as the gain derived from capital, from labor, or from both combined," said that, after examining the dictionaries in common use, the court found little to add to this definition. What he added was:

> provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case.

There could not be a plainer or clearer statement that income under the sixteenth amendment includes such gains in precisely the same way that it included them under the act of 1909, as interpreted by this court. It may be safely said, therefore, that Congress in passing income tax laws, or in levying taxes to be measured by income, has ever since 1864 assumed that income includes gains of the kind involved in this case; that under all the laws passed by Congress the administrative department of the Government has construed income to include such gains; that no

doubt on the part of this court of the correctness of this construction can fairly be said to be implied from anything it has said in interpreting any of the acts of Congress; that nearly every act which Congress has passed dealing with income has had to meet vigorous assaults at the hands of able and astute counsel, but that, until recently, no claim has been advanced that gains of this kind are not income. If any word can be said to have acquired a fixed meaning by congressional, executive, and judicial usage, the word "income" must be understood to include such gains.

III.

In the framing of State income tax laws it has been customary to treat income as including gains derived from the sale of capital assets.

Bearing in mind that we are seeking to ascertain the commonly accepted meaning of the word "income," it may be helpful to refer to income tax laws enacted by the various States. It is true that, in levying taxes, the States are not hampered by a constitutional provision, like the one in the Federal Constitution, requiring apportionment in the case of direct taxes. But when a State enacts a law with the express purpose of taxing income, its enumeration of what shall be included in income throws some light upon the generally accepted meaning of that word. It will be found that, in levying such taxes, the States very generally include, as income, gains derived from the sale of capital assets.

The Virginia income tax law (Acts of Virginia, 1903, c. 148, pp. 155, 160) provides that income shall include, among other things—

> the amount of sales of live stock and meat of all kinds, less the value assessed thereon the previous year by the commissioner of the revenue.

The Wisconsin income-tax act of July 15, 1911 (Laws of Wisconsin, 1911, c. 658, pp. 984, 985), provides that the term "income" shall include, among other things—

> all dividends or profits derived from stock or from the purchase and sale of any property or other valuables acquired within three years previous or from any business whatever.

The Massachusetts act taxes as income—

> the excess of the gains over the losses received by the taxpayer from the purchases or sales of intangible personal property, whether or not the said taxpayer is engaged in the business of dealing in such property. (*Tax Commissioner* v. *Putnam*, 227 Mass. 522, 524.)

The Hawaiian income-tax law (Session Laws of Hawaii, 1901, act No. 20, pp. 31–35) includes as income—

> profits realized within the year preceding from sales of real estate, including leaseholds purchased within two years.

The statutes cited indicate the very general view that income is commonly understood to include such gains as are involved in this case.

There may always be differences of opinion as to the extent to which they shall be taxed when they

have gradually accrued during a period of years; but the power to treat them as income for tax purposes, to whatever extent the legislative body deems proper, would not seem, at this late date, to be open to doubt.

IV.

The cases under the act of 1913 dealing with the distribution of corporate assets among stockholders are in no way in conflict with the Government's contention in this case.

Under the act of 1913 this court had occasion in three cases to determine under what conditions money received by a stockholder as dividends, or as a result of the distribution of corporate assets, was taxable income of the stockholder for the year in which received. These cases are referred to by counsel with the insistence that they are, in some way, in conflict with the contention that gains derived from the sale of capital assets constitute income. It is difficult to see how anything said in these cases can be given that construction. So far as they have any bearing on the question, they tend to sustain the Government's contention in that regard.

In *Lynch* v. *Hornby* (247 U. S. 339), the question was whether a dividend paid to a stockholder in 1914, but out of a surplus accumulated by the corporation prior to March 1, 1913, was income taxable in 1914. The surplus out of which the dividend was paid had been accumulated partly through the business operations of the corporation and partly through a very

great increase in the value of its timber lands. Unquestionably, prior to the declaration of the income the stockholder's interest in the increased valuation of the lands added value to his stock. As long as this value remained a part of the property of the corporation, each stockholder's share was an increment of value incident to and inhering in his stock.

On March 1, 1913, the value of the corporation's capital assets included this increase in the value of its lands. In exactly the same sense, the value of the stockholder's capital assets, represented by his stock, included his share in the increase in value of the lands. In each case it was an element in the value of capital assets. It was, however, an increment of value which had resulted from the investment of capital. It represented that out of which the investor must get his returns or income. The corporation itself would receive this income when it separated the increment of value from the original capital by a sale of the property. Likewise, the stockholder would receive his income when the corporation, after making a sale, paid to him, by way of dividends, his share of the increment of value which had accrued to his stock. As long as this increase remains a mere increment of value, it is, as said in *Eisner* v. *Macomber, supra,* "a gain *accruing to* capital," "a *growth or increment* of value *in* the investment," and is not income. But the moment it is "*severed from* the capital, however invested or employed," it may be said to come in, to be *derived,*

"that is, *received or drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal," and is income derived from property.

The question in *Lynch* v. *Hornby* was, when was the increment of value inhering in the stock severed from the capital of the stockholder—that is, when was it derived from his capital so as to become income to him. That when received as a dividend it was income was not questioned. The contention was that, although income, it had accrued prior to March 1, 1913, and hence, for the purposes of the act of 1913, was capital as of that date. For this reason, it was insisted that, as in the *Turrish* case, the dividends served merely to return to the stockholder his capital as it existed on March 1, 1913. The court, however, said:

> In our opinion it is distinguishable from the *Turrish case*, where the distribution in question was a single and final dividend received by Turrish from the Payette Company in liquidation of the entire assets and business of the company and a return to him of the value of his stock upon the surrender of his entire interest in the company, at a price that represented its intrinsic value at and before March 1, 1913, when the income tax act took effect. (Id., p. 341.)

It was then shown that in *Lynch* v. *Hornby* there was no surrender of the stock, and no winding up of the affairs of the company, but a mere distribution of surplus profits. It was pointed out that Hornby, as one of the stockholders, had only the ordinary

stockholder's interest in the surplus of the company and was entitled to receive anything from accumulated earnings only in the discretion of the directors. While profits derived through the sale by a corporation of capital assets constitute income *to the corporation* at the time of the sale, they do not become income *to the stockholders* until they are distributed. Speaking, therefore, of corporate profits that accumulated before March 1, 1913, but were not distributed until after that date, the court said (p. 343):

> As to these, however, just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus.

And on page 344:

> Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the

dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand.

Thus, what the court held was that the time at which the corporate earnings became income to the stockholders was the time at which they were distributed through dividends and thus received by the stockholders. So far as the case refers at all to the question now involved, it indicates that dividends declared for the purpose of distributing profits made by the profitable sale of capital assets stand upon exactly the same basis as dividends which distribute profits earned in the ordinary business operations of the corporation.

In *Southern Pacific Co.* v. *Lowe* (247 U. S. 330), certain dividends paid to a stockholder out of earnings accruing prior to March 1, 1913, were held not to be income. This was because, however, of the peculiar facts of the case. There was but a single stockholder, and that stockholder not only controlled the corporation but actually had the physical possession and control of all its properties. The court adhered to its ruling in *Lynch* v. *Hornby*, as applied to dividends received by ordinary stockholders, but said:

> While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And, besides, the funds

represented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends. (Id., p. 337.)

In other words, under the peculiar facts of that case, the court was of opinion that the profits in question accrued not only to the corporation but to its sole stockholder before March 1, 1913, and hence that there was no income by the mere change in form of the relation of the two companies to these profits in 1914. For this reason it was held that the stockholder received no income which was taxable under the act of 1913. The only thing in the opinion which can be said to relate, in the slightest degree, to the question now involved is the statement following the holding just referred to (p. 335)—

> And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings and the increment due to an appreciation in value of the assets of the taxpayer.

Peabody v. *Eisner* (247 U. S. 347) involved a dividend paid by a corporation to its stockholder in the stock of another company. The only question involved was whether such a dividend came within the ruling in the *Southern Pacific Company* case or that in the *Hornby* case, and the court said (p. 349):

> In this case the plaintiff in error stands in the position of the ordinary stockholder, whose interest in the accumulated earnings and surplus of the company are not the same

before as after the declaration of a dividend; his right being merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors in their discretion may declare; and without right or power on his part to control that discretion.

There was nothing said in that case which bears in the remotest degree upon the question now involved.

V.

The cases above referred to establish the proposition that gains derived from the sale of capital assets constitute income when received.

The cases which have thus far been reviewed recognize that whatever gains are realized as a result of the investment of money in property constitute income when received. They do not become income until separated from the original capital, and received in such a manner that they may be used by the recipient separate and apart from the capital assets. So long as the investor simply holds the property which he has purchased, any increase in value of that property is an increment of value *in* the investment. While the value of the property is increasing, there is a gain according to capital, but it is to the gain thus accruing, and to the increment of value thus in the investment, that the investor looks, in part, at least, for the returns on his investment. When he sells the property, he is entitled

to withdraw from the proceeds, as capital, the amount invested. The remainder is the returns, the profits, the income, derived from investing his money in property. It is separated from the capital and may be used without disturbing his original capital in the same way that interest paid on money loaned or rents received for the use of land may be used. It possesses all the elements of income and it would seem that the decided cases referred to indicate no room for doubt that it is income within the meaning of the act of 1916, which taxes all income in the year in which it is received.

VI.

Investments are ordinarily made in contemplation of two kinds of returns—one current income while the investment is held, and the other the profit to be realized, through appreciation in value, upon the final disposition of the investment.

That profits derived from the sale of capital assets are income is in accord with the common understanding and practices of men. The investor in property takes many things into consideration in determining whether the investment will be profitable. If his purpose is simply to secure to himself a fixed income, he will invest in property from which he may secure regular returns while he holds the property. On the other hand, he may not be so much interested in the current returns as in the final result of his investment. If so, he may conclude that the circumstances are such that a particular property, though yielding no current returns, is likely to increase very much in

value, and may invest in that property expecting to get the entire return from his investment upon finally making an advantageous sale. One man, therefore, will invest in improved real estate, from which he can derive a fixed rental. He is assured of an income. Ordinarily, however, he will select real estate so situated that it is likely to increase rather than decrease in value. By doing this, he hopes to keep his capital intact, but also indulges the further hope that, through an increase in value, he may at some time be able to sell at a price which will give him a profit over and above the current income which he has received. When he makes such a sale, the surplus over his original capital is a gain. He may then invest exactly the same amount of capital in other property and have, for whatever use he desires, the remainder of the proceeds of sale. The profit realized at the time of the sale has been derived from his capital in precisely the same sense that the rents received while he held the property were so derived.

Another man invests the same amount of money, but chooses to purchase unimproved property, which yields no return, or, at most, only enough to pay the current expenses of holding the property. He makes the investment, however, on his judgment that the property is going to increase very much in value within a few years. It is located in a rapidly growing city. He holds it for five years and sells it for ten times what it cost. Before he makes the sale, a gain has been accruing to his capital. There is an incre-

ment of value in his investment, but he has not taken this increment out and has received no income. When he sells, he takes out of the capital the gain which has been accruing and, after leaving his capital intact, has, separate and apart from it, a specific amount which he has derived from the investment of his capital.

In the two cases above supposed we have this situation: One man has received, from year to year, an income and has been required to pay an income tax on it. At the end of the period he has his capital intact. The other man has, during the same period, had the same amount of money invested, but has received no income and paid no income taxes. At the end of the period he disposes of his investment and takes out his gains in a lump sum. It can not, by any possibility, be said that this lump sum is any less income derived from property than the rents which the other man received from year to year.

It may be supposed that another man invests money in a flock of sheep, expecting to derive an income from the sale of the wool and the lambs. The sheep purchased are capital assets. While the wool is growing on their backs it is a gain accruing, which makes these capital assets more valuable. He may derive his profit in two ways: If he desires to continue to keep the flock of sheep, he shears them, leaving his capital intact, and sells the wool. This is his gain or income derived from the investment of money in sheep. No one would question that it is

taxable income. If he decides to dispose of his investment, however, he can sell the sheep for more with the wool on their backs than after they have been sheared. Suppose that the sheep are still worth just what they cost him, he can sell them the day before shearing for an increased amount to the extent of the value of the wool. If he makes such a sale, instead of shearing the sheep and then selling the wool, is there any reason for saying that, to the extent that the wool added to their value, he has not derived an income from his investment.

Another man decides to invest in bonds. If he buys the bonds at par, he knows exactly what he may expect to get at their maturity. There will be returned to him then exactly the amount he has invested. He can only expect, therefore, as an income from this investment, the interest which will be paid on the bonds. This interest, received from time to time, will be his income. But he frequently finds that business conditions and the demand for money are such that even bonds of undoubted solvency are selling at a discount. He finds that he can purchase bonds at 90 cents and makes an investment on that basis. At the time he invests, he knows exactly what he has to expect if he holds the bonds until maturity. He will receive, from time to time, income represented by the current payments of interest, and at maturity he will have returned to him his original capital plus $10 for every bond of the face value of $100. Can it be said that this $10 is

any less income than the annual interest paid before the maturity of the bonds? Or if, before maturity, he has an opportunity to sell at 95 cents and chooses to do this, is the additional $5 received for each bond any less income than the additional $10 would have been at maturity? Or if, instead of buying bonds, he had loaned his money and taken a note due 10 years from date, with interest payable at maturity, can it be said that the accumulated interest received according to contract at the maturity of the note is any less income than it would have been if divided into 10 equal parts and paid annually?

Still another man invests in corporate stocks. The value of such stocks at any particular time depends upon many considerations. He can not know what they will be worth at any particular time in the future, nor is he absolutely assured that he will, from time to time, receive a particular amount or any amount by way of dividends. These things will all depend upon the degree of prosperity which the corporation enjoys. If the corporation is prosperous and distributes a reasonable amount of its profits as dividends, he expects to receive a return in this way on his investment, and, as it is received, he must report it as taxable income. The company, however, may earn much more in the way of profits than its directors see fit to distribute in dividends. If so, these accumulated earnings add to the market or selling value of his stock. When he sells the stock, he gets the benefit of his share of these earnings in the

increased price. Is there any difference in principle between the gain thus received and the gains which he has received in the way of dividends?

It may be supposed that it is known that, on the 1st day of January of a particular year, the corporation will declare a dividend of 10 per cent. When this dividend is declared, the selling price of his stock will, for the time being, be to that extent, decreased. The day before the dividend is declared he can sell his stock for more than he can sell it for the day after the dividend is paid. Instead of waiting for the dividend, he sells his stock and gets, as a part of the purchase price, exactly the same 10 per cent which he would have gotten if he had held his stock and received the dividend in cash. In either event, he has derived from his investment 10 per cent of the par value of his stock. Is there any reason why this 10 per cent should be income in the one case and not income in the other?

What is attempted to be shown by the above illustrations is true of almost every transaction by which men invest money in property. If the gains made by purchasing, holding, and selling property are not income, then income derived from property will be confined within a very narrow scope, and the result will be that whether gains actually derived from the investment of money in property are taxable will depend, not upon the substance and effect of the transaction, but upon the form in which the investor chooses to clothe it.

VII.

The debates in Congress, when the act of 1913 was under consideration, do not show an understanding that such gains as are now in question were not understood to be income.

Counsel insist that the debates in Congress in 1913 show that Congress understood that such gains as those now in question are not income. In support of this contention, they quote from a statement made by Representative Hull when he was explaining to the House the provisions of the act of 1913. In answer to a question as to what would be the taxable income if a man this year sells property bought many years ago at a price not greater than its value last year, his reply was:

> My judgment would be that as to an occasional purchase of real estate not by a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land was purchased and sold during the same year. (50 Cong. Rec., pt. 1, p. 513.)

It will be noted that the question related to the provisions of the then pending bill. That bill, as above shown, followed the language of the act of 1867 and levied the tax on income arising or accruing during a particular year. Similar language in the act of 1867 having been held to confine the income from such a transaction intended to be taxed to income arising from a transaction both begun and ended in the same year, the natural inference was,

as stated by Mr. Hull, that the act of 1913 would be construed in the same way. The purpose to tax income arising from the sale of capital assets was, however, clearly expressed.

The only question was whether it should be confined to transactions occurring wholly within one year. Moreover, an examination of the full statement of Mr. Hull from which the above is taken, as it appears in the Congressional Record for April 26, 1913 (50 Cong. Rec., pt. 1, p. 513), shows that, throughout the statement, gains of this kind were regarded as income. The particular questions discussed were, what part of gains accruing during a period of years should be taxed in the year in which they were received, and also what deductions in the way of losses should be allowed. As shown above, under the act of 1909, the administrative department had prorated such gains according as the number of years during which they accrued was before and after the effective date of the act. It seems to have been assumed in the discussion that this method would be followed under the act of 1913. These questions, however, are not important as bearing upon the act of 1916. After the act of 1913 had been tried out, Congress, in framing the act of 1916, departed from the plan of levying the tax on income arising or accruing during a particular year and levied it upon the income received during the year. This changed entirely the rule which Mr. Hull supposed would apply to the act of 1913 by confining the tax to gains made in transactions begun and ended

during the year. It also departed from the prorating rule, which it was assumed would apply under the act of 1913, by making the value on March 1, 1913, the basis for determining the amount of gains. The statement quoted from Senator Clark as having been made during the debate in the Senate when the act of 1916 was under consideration, to the effect that a man would not be taxed at all if he purchased stocks in one year and two years thereafter sold them at an advance of $20,000, is the mere expression of an opinion by an individual Senator. As shown above, when the language of the act is examined, the opinion is clearly erroneous, probably overlooking the difference in the wording of the act of 1916 and that of 1913.

VIII.

The tax on gains derived from the sale of property is not confined to such gains arising from transactions conducted as a part of one's business or trade.

It is admitted that when, as a part of one's business or trade, he sells capital assets, and thereby derives a profit, the gain so derived becomes a part of the income of his business upon which he is taxed. It is insisted, however, that the act has no application to gains derived from an occasional or isolated sale of property which has been purchased as an investment. No language of the act is pointed out drawing any such distinction. The tax is levied broadly on gains derived from sales of property. The only thing in the act to which counsel can refer as giving any color to their claim is the provision allowing

deductions for losses. It is true that the general deduction for losses is made only for losses occurring in the conduct of a business. In addition, a deduction under certain circumstances is allowed for losses occurring not in the course of a business. This deduction is prescribed as follows in section 5 of the act:

> In transactions entered into for profit but not connected with his [the taxpayer's] business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom. (39 Stat., p. 759.)

The reason for these provisions is obvious. When one is engaged in a business requiring many transactions during a year he will doubtless make a profit on some and suffer a loss on others. The only fair way to ascertain what his income is, is to strike a balance between the gains and losses constituting his business, and hence business losses are permitted to be deducted. If, however, a man has but one transaction during the year, that transaction results in either a profit or a loss. If there is a profit, it is undoubtedly income to him; and if there are no other similar transactions, there are no losses to deduct. On the other hand, the Government does not guarantee to anyone an income or a profit on any transaction into which he enters. If, therefore, the single transaction results in a loss, he has simply failed to obtain an income which the Government can tax. If, however, he has an income from other

sources—as a salary or returns from fixed investments—there is no reason why he may not be required to pay a tax on the income actually received from these sources, without any deduction on account of his failure to make a profit in some other venture. In the provision above quoted, Congress has accorded a full measure of consideration to the occasional investor. It is assumed that one may, in the course of a year, though not engaged in a regular business, have several transactions out of which either gains or losses may result. It is, therefore, provided that, to the extent that he realizes profits from any of these transactions, he may offset losses that have resulted from other transactions. In other words, the investing of money for profit is put upon the same basis as conducting a regular business. A balance is struck between the gains and losses resulting from such transactions, and this balance is treated as the income from the combined transactions. A man who purchases any kind of property is ordinarily entering into a transaction from which he expects profit to result, although he may expect, in the meantime, to use the property for his own purposes.

In the case of deductions for business losses, these deductions are only allowed as against the gains incurred in that business. For instance, a merchant during a particular year, while making large profits in some lines, may suffer losses to a very much larger amount in other lines. The result will be that the losses of his business wipe out entirely the taxable income and, in fact, leave him a loser. He may,

however, be the recipient of a large income from other sources, entirely disconnected from his business as a merchant. As against this income, he can not deduct or set off the net losses incurred in his mercantile business. The same rule, as we have seen, applies to one who has both gains and losses in transactions not connected with his trade or business.

On the whole, the act would seem, in this regard, to have been framed upon principles of fairness and justice. But if its entire justice was not apparent, and its provisions deemed unwise, Congress alone could give relief.

IX.

Whether under the decisions of the English courts gains of this kind are treated as income can have no determining effect in deciding the question now at issue.

It is stated in the brief that the settled law in Great Britain is that the growth or increment of value in investments or the capital assets of a corporation when realized by sale (as distinguished from profits so realized where such sale is the taxpayer's trade or business) is principal or capital and not income, within the scope of the income tax laws of Great Britain and the British Dominions. A large number of cases are cited to support this statement. An examination of these cases, however, can throw but little light on the present question. In practically all, if not all, the cases cited, the question was whether the act of parliament levying a particu-

lar tax expressed the intention to tax such gains. The British Parliament is fettered by no such constitutional provisions as control the Congress of the United States in levying taxes. Its right to tax income does not depend upon a Constitution which distinguishes between the methods in which income taxes and direct taxes may be levied. The parliament, therefore, may, for purposes of a particular act, define income to include anything it chooses. Whether, therefore, it has in its various acts treated gains of this kind as income has been determined purely by considerations of policy. If, therefore, it has not seen fit to tax gains derived from the sale of capital assets, it does not follow by any means that such gains are not included in the term "income" as commonly understood. On the contrary, it merely results that the parliament has not deemed it wise to tax such gains, and therefore has excluded them from the definition of "income" which it adopted for the purposes of particular acts.

X.

The fact that under the laws of various States gains derived from the sale of capital assets are, as between a life tenant and a remainderman, treated as principal and not as income affords no reason for saying that such gains are not income which Congress may tax.

Great stress is laid by counsel upon the fact that in many of the States gains resulting from the sale of assets held in trust for the payment of income to a life tenant are treated, as between life tenant and

remainderman, as principal and not as income. On this is based an argument which the Government found unavailing in *Eisner* v. *Macomber*, *supra*. In that case the Government relied largely upon the fact that, under the laws of most of the States, stock dividends go to the life tenant and not to the remainderman. This court, however, held that, even in the States where this rule prevailed, stock dividends for the purpose of Federal taxation are not income. The rule prevailing in the various States is entitled to even less weight in this case. The terms upon which property is held in trust are prescribed by the instrument creating the trust. In determining the rights, therefore, of life tenant and remainderman, the courts are concerned alone with ascertaining the intent and meaning of that instrument. No technical rules of law are involved. The question is simply what did the creator of the trust intend. The purpose of creating a trust for the benefit of a life tenant is ordinarily to secure for that tenant as nearly a fixed and certain income as possible. If specific property is conveyed to the trustee, the author of the trust knows, within reasonable limits, what income will, in the ordinary course of events, result.

Conditions, however, may entirely change and it is usual to authorize the trustees, if they find it necessary, to change the income producing investment. This is generally authorized in such language as makes it clear that the intention is for the life tenant to receive only the ordinary income from

specific property or from such other property as may be substituted for it. In other words, almost invariably the trust instrument is so worded as to make clear the intention that the life tenant shall only receive the ordinary income from property and that any increase in the value of that property, whether realized or unrealized, shall inure to the benefit of the remainderman. In such cases, it does not follow that, by an advantageous sale of the trust property, the trustee has not received taxable income. He is required to pay the ordinary income from specific property to the life tenant. If he sees fit to sell this property, he is required to invest the proceeds in other income-producing property, and the ordinary income from the latter property must also be paid to the life tenant. But in making a profitable sale, he, like any other person, realizes for his beneficiary a profit, a gain, an income. True, under the terms of his trust, this income must be invested and the income from that investment also goes to the life tenant. If the law levying an income tax requires trustees, like individuals, to account for and pay a tax on income received, he will be required to pay a tax on this profit. The life tenant will probably be entitled to have this tax charged against the proceeds of the sale and not taken out of the ordinary income of the trust. The gains made by such a sale are taxable income. Whether, as between the life tenant and the remainderman, they go to the one or the other depends entirely upon the intent expressed

by the instrument creating the trust. The cases, therefore, to which counsel have referred can have no possible application to the question of whether gains of a particular kind are income within the common and ordinary acceptation of that term.

XI.

The construction of the act of 1916, under which the taxes in this case were collected, does not work any more hardship or injustice than is inevitable under any general tax law.

Counsel have cited certain examples of cases in which they say the Government's construction of the act of 1916 works hardship and inequality.

(*a*) It is said that there is great injustice in allowing deductions for losses in the case of a going business and not in other transactions. As we have seen, the law admirably guards against injustice in the matter of deductions for losses. The losses of a going business are deducted merely for the purpose of seeing what the net result or income of that business has been. And in the case of transactions for profit not connected with a regular business, exactly the same rule is applied. All these transactions are treated as a whole, and only the excess of profits over losses arising from them is taxed. It is difficult to see how any injustice results to anyone from this.

(*b*) It is said that in the case of property held for a long period by an investor, or as an investment of trust funds by a fiduciary, losses are not deductible

because such transactions are not entered into for profit. A sale is a transaction. If no profit results from it, no taxable income arises. If a profit does result, it requires no stretch of the imagination to say that the transaction was entered into, at least partly, for the purpose of securing the profit. If a sale is made for purposes of reinvestment, it is not an unfair inference that the controlling reason for the sale is that a more profitable investment can be obtained. If there have been a series of such sales during a given year, some resulting in losses and some in gains, it is not at all uncertain that the losses may not be deducted from the gains. If not, the most that could be said against the act is that, in this respect, Congress has failed to attain complete equality.

(*c*) It is said that great injustice is done by requiring the profit which has resulted from an increase in value through a period of years to be taxed as the income of the year in which it is received instead of prorating it through the years when it was accruing. This, however, was a matter which addressed itself to the legislative judgment. The prorating system would have entailed great administrative difficulties. A tax could not be levied each year during which the property was increasing in value, but during which it remained unsold. Such increases are subject to be controlled by changing conditions, and may finally be converted into losses.

Until received in some form, these increases are not income. To undertake to prorate them over a period

of years when they are received would require reassessments for those years. This alone would have been sufficient to justify Congress in rejecting the prorating plan. Moreover, the recipient of such gains gets the full enjoyment of the whole of them at the time they are actually received—that is, the time at which they became income. No part of them constituted income of a previous year, because they were then, at most, mere speculative or paper gains. The simplest and, after all, the most just way of treating the matter would be to say, as Congress has said, that these gains shall be treated as income of the year in which they are received. It is true that if the rate of taxation has been increased the taxpayer pays more taxes by delaying a sale of his principal. But, on the other hand, if the rate of taxation is decreased, he is the gainer by the delay. At any rate, if he goes free of taxes during the years when his property is increasing in value, it is difficult to see any great injustice in requiring him to pay taxes on his gains when they are actually received. But if it could be shown that, in some cases, the law bears harshly and unjustly upon some taxpayer, this would not justify the court in declaring the law invalid. As this court has frequently said, inequalities are unavoidable in the levying of any general tax. In view of this, the weakness of the cases of hardship pointed out would indicate that, with respect to the questions now at issue, Congress has succeeded to an unusual extent in attaining equality and justice.

XII.

The application of the law to the two transactions involved in this case.

So far as plaintiff in error seeks to recover the taxes paid on account of the United Verde Extension Mining Company stock transaction there is no difficulty. He purchased the shares in 1912 for $500 and sold them in 1916 for $13,931.22, making a clear gain on the transaction of $13,431.22. It appears, however, that the stock from the time he bought it increased in value, so that on March 1, 1913, it was worth $695. The Commissioner of Internal Revenue, correctly construing the law to entitle him to withdraw as capital from the proceeds of sale the value of his stock on March 1, 1913, deducted $695 instead of the original purchase price and collected the tax on the remainder, or $13,236.22. For the reasons above stated, plaintiff in error was plainly liable for the tax so collected.

With respect to the B. F. Goodrich stock, the situation is different. Plaintiff in error acquired this stock in 1912. It was acquired in a transaction in which he received this stock and a certain amount of cash in exchange for other stocks, which he had previously acquired by gift and bequest. He thus received 3,600 shares, which were worth $81 per share, or $291,600. He sold them in 1916 for $269,346.25, making a net loss on the entire transaction of $22,253.75. But it appears that, after he acquired these shares, their market value very rapidly declined until on March 1, 1913, the stock of the

company sold on the New York Stock Exchange at something in excess of $41 per share. On this basis the Commissioner of Internal Revenue determined that the total value on March 1, 1913, of plaintiff in error's 3,600 shares was $148,635.50. Holding that this was the capital value which was entitled to be withdrawn, as capital from the proceeds of sale, he deducted that amount from the selling price of $269,346.25, and collected taxes on the balance, or $120,710.75. It will be seen that, on the entire transaction, there was no gain, but, on the contrary, a loss of more than $22,000. The question is whether in such a case any taxable income was received. The theory of the commissioner was that the act of Congress capitalized the assets of a taxpayer at their value as it existed on March 1, 1913. In other words, he ruled that the value, as of that date, must always control, and that in all cases the difference between this value and a higher selling price is income received when the sale is made.

If this construction of the law is correct, a serious constitutional question arises. Whatever gains are made by selling property resulted from three acts—acquisition, holding, and selling. These three acts together resulted in a gain or a loss, according as the selling price is more or less than the acquisition price. It is said, therefore, that unless the entire transaction composed of the three acts mentioned results in a gain there is, in fact, no income. It is true that, between the date of acquisition and the date of sale, the market price of the property may have fluctuated,

so that there may have been times when a sale could have been made at a profit; but if the owner did not choose to sell and take his profit, no income, in fact, resulted from his mere ability to have done so. On the other hand, there may have been times when, if the owner had sold, his loss would have been greater than it was at a later date when he actually sold. But it is said that he was not required to sell when the price was at its lowest and take his loss, and that if he did not do so the question as to whether he finally made a profit or suffered a loss must be determined by comparing the purchasing and selling prices. In other words, the contention is that, under the commissioner's construction of the law, something is taxed which is not, in fact, income and which Congress was therefore without the power to tax except by apportionment.

After a careful study of the statute, the Solicitor General is forced to the conclusion that the commissioner has erroneously construed the statute. It clearly imposes the tax only on *gains* that are derived from the sale of property. It can not be said that there has been a gain resulting from a sale of property at less than it cost, no matter how long an interval may have intervened between the purchase and the sale. The error consists in giving too broad a scope to the rule laid down by the statute for determining the amount of taxable gain derived from sales made during a particular year. From the beginning, the income-tax acts had imposed a tax only upon gains derived from sale. As shown above, there had

been much discussion and difference of opinion as to whether all such gains should be taxed in the year in which received. It was contended that it would be unjust to tax all of such gains when they had resulted from a gradual increase in values during a long period of years. Following the act of 1867, it was, at first, thought that such gains should be taxed only when the transaction from which they resulted both began and ended in the tax year, or, at least, when the property had been purchased only a short time before the beginning of that year. There was also a doubt of the power of Congress to tax that portion of such gains which would be represented by the increase in value which had occurred prior to the adoption of the sixteenth amendment.

After much discussion, Congress determined that it would not confine the tax to gains made in transactions beginning and ending in the particular year, or within any fixed and arbitrary time before that year, but that it would simply exclude so much of the gains as could be said to have resulted from increases in value prior to March 1, 1913, practically the date of the adoption of the sixteenth amendment. There had also been a difference of opinion as to how, in such cases, the gains should be apportioned between taxed and nontaxed gains. Under the act of 1909 the Internal Revenue Department had adopted a prorating method, according to the number of years the property was held before and after the effective date of the act. Congress apparently regarded this method unsatisfactory, and

instead concluded that the better plan was to ascertain the amount of gains resulting from increase in value before March 1, 1913, by comparing the value on that date with the original cost price. When, therefore, it adopted the provision, which will be quoted below, it was dealing with the question as to how ascertained gains should be divided for the purpose of taxation under this act, or for ascertaining the income which Congress intended should be taxed in a particular year. For this purpose it used the following language:

> For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived. (39 Stat., c. 463, sec. 2 (c), p. 758.)

It seems difficult to escape the conclusion that this provision can have no application until it is first ascertained, by comparing the purchase and selling prices, that there has been an actual gain. When this has been ascertained, the value of the property on March 1, 1913, is to be taken as including that portion of the increase in value finally realized by a sale which occurred subsequent to that date. But when the selling price is less than the purchase price, there has been a loss instead of a gain, and hence there is nothing to which the value on March 1, 1913, can be applied.

Under a proper construction of the act, therefore, it must be conceded that the plaintiff in error was not liable for a tax on account of his transaction in the B. F. Goodrich Company stock.

Having made this concession, however, it is proper to make clear the Government's view with respect to a similar and related matter. As shown above, losses sustained in business or trade or in transactions entered into for profit are, under certain conditions, permitted to be deducted. Where these losses are allowed and have resulted from the sale of property purchased before March 1, 1913, Congress has made provision for ascertaining the amounts of such losses that may be deducted in much the same language used in providing for ascertaining the amount of income from such sources to be taxed in a particular year. The provision is as follows:

> *Provided*, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained. (39 Stat., c. 463, p. 759.)

This provision, therefore, must be construed as it has been conceded the similar provision relating to income is to be construed—that is, it must first be ascertained by comparing the purchase and selling price that a loss on the entire transaction has been

sustained. When this fact is ascertained, we look to the value of the property on March 1, 1913, to determine how much of the loss resulted from a decrease in value prior to that time. Thus, if property was bought in 1910 for $2,000 and sold in 1916 for $1,000, there was a loss of $1,000. Since all gains, under similar circumstances, are not taxed as income, there was a similar purpose not to allow all such losses. Therefore, if it appeared that on March 1, 1913, the value of the property had decreased until it was worth only $1,500, $500 of the entire loss would be regarded as having resulted from decrease in value occurring before that date, and hence only the remaining $500 of the loss would be allowed as a deduction. On the other hand, if the value of this property had increased until it was worth $2,500 on March 1, 1913, and had then decreased in value until it was finally sold for $1,000, the actual loss would still be $1,000; but the fact that all of this decrease had occurred since March 1, 1913, would be established by the advanced value as of that date, and hence the entire $1,000 would be deductible, and the taxpayer would not be entitled to deduct the difference between the full market value on March 1, 1913, and the selling price. Again, if it appeared that the value had decreased until on March 1, 1913, the property was worth only $1,000 and was later sold for $1,000, there would still be a loss of $1,000; but no deduction would be allowed because the market value of $1,000 on March 1, 1913, would establish the fact that the entire loss had resulted from a decrease in value occurring before that date.

In the present case, if it could be said that, in any event, the plaintiff in error could deduct from the income derived from one transaction the losses suffered through the other, he would not be entitled to a deduction. The reason is that, while he suffered a loss on the entire transaction, the value of the stocks had so greatly decreased before March 1, 1913, that if he had sold then his loss would have been very much greater. He did not choose to take his loss at that time, but held the stock for a higher price, which he finally obtained. In other words, the entire decrease in value which resulted in his final loss occurred prior to March 1, 1913. There was thereafter no decrease in value which resulted in a loss, but, on the contrary, an increase in price which overcame, in part, the previous decrease, and there was no loss occurring under the terms of the act after March 1, 1913, which can be deducted.

From what has been said, it results:

1. The taxes paid on the gain derived from the sale of the mining company stock were properly collected.

2. There was no gain resulting from the sale of the B. F. Goodrich Company stock, and the taxes collected on account of that transaction were improperly collected.

3. The plaintiff in error is not entitled to any deduction from the income derived from the first transaction on account of losses sustained in the second.

CONCLUSION.

The demurrer, being general, it follows, from the concession made above, that the judgment of the court sustaining it and dismissing the suit must be reversed, but the reversal should be placed alone upon the ground that the declaration makes a case in which the plaintiff in error is entitled to recover one of the items of taxes sued for but not the other.

Respectfully submitted.

WILLIAM L. FRIERSON,
Solicitor General.

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